

ORIGINAL



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# ARIZONA WATER COMPANY

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October 29, 2004

AZ CORP COMMISSION  
DOCUMENT CONTROL

Arizona Corporation Commission  
**DOCKETED**

OCT 29 2004

Mr. Ernest G. Johnson, Esq., Director  
Utilities Division  
Arizona Corporation Commission  
1200 West Washington Street  
Phoenix, AZ 85007

|             |  |
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| DOCKETED BY |  |
|-------------|--|

Re: Response To Staff Report (Docket No. W-01445-04-0498)

Dear Mr. Johnson:

The Commission Staff issued its Staff Report in this matter on October 4, 2004. The Staff Report recommends issuing an accounting order authorizing the Company to defer arsenic treatment costs incurred in its Western Group for future Commission consideration for recovery as summarized below:

1. Deferral of depreciation expense for the actual cost to purchase each arsenic treatment facility for a period not to exceed twelve months.
2. Deferral of the actual lease capital costs (standby fee) for each leased arsenic treatment facility for a period not to exceed twelve months.
3. Eligibility to defer leased capital costs is contingent upon meeting the following criteria:
  - a. The lease payment must segregate the lessor's equipment construction costs, recoverable O&M costs defined as media replacement or regeneration costs, media replacement or regeneration service costs and waste media or regeneration disposal costs, and the lessor's embedded interest rate.
4. Operation and Maintenance expenses are limited to recoverable O&M expenses defined above.
5. Property taxes associated with arsenic treatment plant are not eligible for deferral.
6. No deferrals shall be recorded after January 2007.

E-MAIL: [mail@azwater.com](mailto:mail@azwater.com)

To: Mr. Ernest Johnson

October 29, 2004

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The Staff and Company agree on the need for an Accounting Order authorizing the Company to defer arsenic treatment costs incurred in its Western Group for future consideration of recovery by the Commission. However, the Company strongly disagrees with the deferral methodology Staff recommends and its perverse effects which unfairly reduce the Company's arsenic treatment facility ratebase while also increasing the amount of ACRM revenue that customers will have to pay. I am bringing this to your attention for reconsideration because I do not believe the Commission would knowingly choose such an outcome.

The Company is not requesting a hearing on this matter. The time to prepare testimony, participate in a hearing and then assist in the preparation of briefs would take more time than the Company can reasonably devote to this matter at the present time. Therefore to save time and legal expenses the Company requests that its objections be considered without a hearing.

The ACRM in effect for the Northern and Eastern Groups permits the Company to file for recovery of arsenic treatment facility capital costs as soon as the facility is placed in service. However all of the Western Group arsenic treatment facility capital costs will be incurred before an ACRM can even be authorized as part of the Company's pending rate application. Although no return will be earned on the purchased arsenic treatment facility capital costs until the first Western group ACRM filing is approved & becomes effective, the Company has not requested a deferred return or depreciation expense. In its Application the Company simply requested that the purchase cost of arsenic treatment facilities be deferred until the first ACRM filing. This approach preserves the Company's investment until an ACRM filing is made and produces a lower ACRM revenue requirement.

Staff differs with the Company and instead recommends that depreciation expense, but not a return on the investment, be deferred beginning with the in-service date of the arsenic treatment facility. Staff supports its alternative position with a fallacious accounting argument asserting that "The Company's proposal to record purchased arsenic treatment facilities in a deferred debit account effectively provides for authorization of recovery, not simply deferral for future consideration of recovery." This assertion contradicts the plain language of the Uniform System of Accounts. For example, the 1996 USOA discussion of A/C 186 Miscellaneous deferred debits includes the following language regarding Regulatory Assets:

- C. "If rate recovery of all or part of the amount included in this account is disallowed, then the disallowed amount..." (emphasis added)

The more general category of items charged to the account as described on page 73 A. is "... items the final disposition of which is uncertain." The Company's proposal deferring only the purchase cost or lease capital costs does not provide authorization of recovery as a reading of the USOA clearly states. More importantly, the Commission's eventual ratemaking treatment of an item is certainly not constrained by the original accounting.

The deferral methodology recommended by Staff penalizes both the Company and ratepayers. The effects of the Company and Staff deferral methodology over the period from

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Re: Response To Staff Report (Docket No. W-01445-04-0498)

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January 1, 2005 through December 31, 2009 are compared on the enclosed Exhibit 1. Both sets of calculations are based on the following set of realistic assumptions:

- \$13.6 million of purchased arsenic treatment facilities are placed in service January 2005.
- The first Western Group ACRM filing is effective January 2006.
- The Western Group participates in a Company-wide general rate case application based on test year 2006 that is filed September 2007 with new rates becoming effective January 2009.

The Company's methodology (illustrated on the left side of Exhibit 1) records the purchase cost of the arsenic treatment facilities in a deferred debit account as shown on line 1 and does not recognize depreciation or a return until the first ACRM becomes effective. Staff's deferral methodology (illustrated on the right side of Exhibit 1), which was confirmed in a meeting with Staff on October 26, begins recording depreciation but not a return as soon as the arsenic treatment facilities are placed in service as shown on line 1, Exhibit 1. Since the accumulated depreciation is not being recovered through the rates, the expense portion of the depreciation is recorded in a deferred debit account for future recovery.

The initial effects of these differing deferral methodologies are apparent at the time the first ACRM filing becomes effective as shown on line 13 of Exhibit 1. Under its proposal the Company has a ratebase of \$13,600,000, which results in an initial monthly revenue requirement of \$193,373. In contrast, the Staff's ratebase is \$13,211,040 or \$388,960 less and the initial monthly revenue requirement is \$211,183, 14.4% more than under the Company's proposal. This rather perverse result occurs because of the deferral of depreciation rather than plant. The \$388,960 deferred debit that appears on line 13 under Staff's methodology must be amortized (expensed). The required amortization of \$32,413 per month directly increases the Staff ACRM revenue requirement.

Staff's proposed methodology unnecessarily increases customers' rates and lowers the Company's return as illustrated on Exhibit 1. This is true whether measured on a discounted present value basis as shown at the top of the Exhibit or just a straight accumulation over the 60-month period as illustrated at the bottom of the Exhibit. The Company provided written comments and met with the Staff to discuss its analysis comparing the effects of the two positions in an attempt to reach an agreement on the deferral methodology. Although Staff confirmed that the analysis correctly depicted their recommended methodology, they did not provide any other direct comments on the analysis. Unfortunately no agreement was reached. Therefore I request you to review the record in this matter and reconsider the effects of Staff's deferral methodology on the Company and its customers.

**ARIZONA WATER COMPANY**

To: Mr. Ernest Johnson

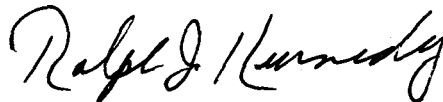
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Very truly yours,

A handwritten signature in cursive script, appearing to read "Ralph J. Kennedy".

Ralph J. Kennedy

Vice President and Treasurer

jrc  
Enclosure

# Arizona Water Company

Exhibit 1

## AWC Methodology To Defer Plant Purchase Cost

| Present Value Of Revenue Requirement:<br>Shown On Lines 13 Through 60 | P.V. Rate | Revenue Requirement |
|---|-----------|---------------------|
| \$8,192,908   | 6.0%      | \$8,192,908         |
| \$7,882,734   | 8.0%      | \$7,882,734         |
| \$7,588,735   | 10.0%     | \$7,588,735         |

| Month  | Line | Deferred Debit | Plant in Service | Accumulated Depreciation | Adjusted Rate Base | Return @ 8.70% | Gross Return | Depreciation | Revenue Requirement |
|--------|------|----------------|------------------|--------------------------|--------------------|----------------|--------------|--------------|---------------------|
| Jan-05 | 1    | 13,600,000     |                  |                          |                    |                |              |              |                     |
| Feb-05 | 2    |                | 13,600,000       |                          |                    |                |              |              |                     |
| Mar-05 | 3    |                | 13,600,000       |                          |                    |                |              |              |                     |
| Apr-05 | 4    |                | 13,600,000       |                          |                    |                |              |              |                     |
| May-05 | 5    |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jun-05 | 6    |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jul-05 | 7    |                | 13,600,000       |                          |                    |                |              |              |                     |
| Aug-05 | 8    |                | 13,600,000       |                          |                    |                |              |              |                     |
| Sep-05 | 9    |                | 13,600,000       |                          |                    |                |              |              |                     |
| Oct-05 | 10   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Nov-05 | 11   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Dec-05 | 12   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jan-06 | 13   | (13,600,000)   |                  |                          |                    |                |              |              |                     |
| Feb-06 | 14   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Mar-06 | 15   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Apr-06 | 16   |                | 13,600,000       |                          |                    |                |              |              |                     |
| May-06 | 17   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jun-06 | 18   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jul-06 | 19   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Aug-06 | 20   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Sep-06 | 21   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Oct-06 | 22   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Nov-06 | 23   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Dec-06 | 24   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jan-07 | 25   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Feb-07 | 26   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Mar-07 | 27   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Apr-07 | 28   |                | 13,600,000       |                          |                    |                |              |              |                     |
| May-07 | 29   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jun-07 | 30   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jul-07 | 31   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Aug-07 | 32   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Sep-07 | 33   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Oct-07 | 34   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Nov-07 | 35   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Dec-07 | 36   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jan-08 | 37   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Feb-08 | 38   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Mar-08 | 39   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Apr-08 | 40   |                | 13,600,000       |                          |                    |                |              |              |                     |
| May-08 | 41   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jun-08 | 42   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jul-08 | 43   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Aug-08 | 44   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Sep-08 | 45   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Oct-08 | 46   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Nov-08 | 47   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Dec-08 | 48   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jan-09 | 49   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Feb-09 | 50   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Mar-09 | 51   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Apr-09 | 52   |                | 13,600,000       |                          |                    |                |              |              |                     |
| May-09 | 53   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jun-09 | 54   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Jul-09 | 55   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Aug-09 | 56   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Sep-09 | 57   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Oct-09 | 58   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Nov-09 | 59   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Dec-09 | 60   |                | 13,600,000       |                          |                    |                |              |              |                     |
| Total  |      |                |                  |                          |                    |                |              |              | 9,231,261           |

ACRM #1

E.O. TV

GRC Filed

Decision New Rates Rate Base @ 12/31/06

## Staff Methodology To Defer Depreciation Expense

| Present Value Of Revenue Requirement:<br>Shown On Lines 13 Through 60 | P.V. Rate | Revenue Requirement |
|---|-----------|---------------------|
| \$8,373,500   | 6.0%      | \$8,373,500         |
| \$8,066,785   | 8.0%      | \$8,066,785         |
| \$7,775,916   | 10.0%     | \$7,775,916         |

| Month  | Line | Deferred Debit | Plant in Service | Accumulated Depreciation | Adjusted Rate Base | Return @ 8.70% | Gross Return | Depreciation | Revenue Requirement |
|--------|------|----------------|------------------|--------------------------|--------------------|----------------|--------------|--------------|---------------------|
| Jan-05 | 1    | 32,413         |                  |                          |                    |                |              |              |                     |
| Feb-05 | 2    | 64,827         |                  |                          |                    |                |              |              |                     |
| Mar-05 | 3    | 97,240         |                  |                          |                    |                |              |              |                     |
| Apr-05 | 4    | 129,653        |                  |                          |                    |                |              |              |                     |
| May-05 | 5    | 162,067        |                  |                          |                    |                |              |              |                     |
| Jun-05 | 6    | 194,480        |                  |                          |                    |                |              |              |                     |
| Jul-05 | 7    | 226,893        |                  |                          |                    |                |              |              |                     |
| Aug-05 | 8    | 259,307        |                  |                          |                    |                |              |              |                     |
| Sep-05 | 9    | 291,720        |                  |                          |                    |                |              |              |                     |
| Oct-05 | 10   | 324,133        |                  |                          |                    |                |              |              |                     |
| Nov-05 | 11   | 356,547        |                  |                          |                    |                |              |              |                     |
| Dec-05 | 12   | 388,960        |                  |                          |                    |                |              |              |                     |
| Jan-06 | 13   | 388,960        | 13,600,000       |                          | 13,211,040         | 95,780         | 156,356      | 32,413       | 221,183             |
| Feb-06 | 14   | 356,547        | 13,600,000       |                          | 13,178,627         | 95,780         | 156,356      | 32,413       | 221,183             |
| Mar-06 | 15   | 324,133        | 13,600,000       |                          | 13,146,213         | 95,780         | 156,356      | 32,413       | 221,183             |
| Apr-06 | 16   | 291,720        | 13,600,000       |                          | 13,113,800         | 95,780         | 156,356      | 32,413       | 221,183             |
| May-06 | 17   | 259,307        | 13,600,000       |                          | 13,081,387         | 95,780         | 156,356      | 32,413       | 221,183             |
| Jun-06 | 18   | 226,893        | 13,600,000       |                          | 13,048,973         | 95,780         | 156,356      | 32,413       | 221,183             |
| Jul-06 | 19   | 194,480        | 13,600,000       |                          | 13,016,560         | 95,780         | 156,356      | 32,413       | 221,183             |
| Aug-06 | 20   | 162,067        | 13,600,000       |                          | 12,984,147         | 95,780         | 156,356      | 32,413       | 221,183             |
| Sep-06 | 21   | 129,653        | 13,600,000       |                          | 12,951,733         | 95,780         | 156,356      | 32,413       | 221,183             |
| Oct-06 | 22   | 97,240         | 13,600,000       |                          | 12,919,320         | 95,780         | 156,356      | 32,413       | 221,183             |
| Nov-06 | 23   | 64,827         | 13,600,000       |                          | 12,886,907         | 95,780         | 156,356      | 32,413       | 221,183             |
| Dec-06 | 24   | 32,413         | 13,600,000       |                          | 12,854,493         | 95,780         | 156,356      | 32,413       | 221,183             |
| Jan-07 | 25   | 0              | 13,600,000       |                          | 12,822,080         | 95,780         | 156,356      | 32,413       | 221,183             |
| Feb-07 | 26   |                | 13,600,000       |                          | 12,789,667         | 95,780         | 156,356      | 32,413       | 221,183             |
| Mar-07 | 27   |                | 13,600,000       |                          | 12,757,253         | 95,780         | 156,356      | 32,413       | 221,183             |
| Apr-07 | 28   |                | 13,600,000       |                          | 12,724,840         | 95,780         | 156,356      | 32,413       | 221,183             |
| May-07 | 29   |                | 13,600,000       |                          | 12,692,427         | 95,780         | 156,356      | 32,413       | 221,183             |
| Jun-07 | 30   |                | 13,600,000       |                          | 12,660,013         | 95,780         | 156,356      | 32,413       | 221,183             |
| Jul-07 | 31   |                | 13,600,000       |                          | 12,627,600         | 95,780         | 156,356      | 32,413       | 221,183             |
| Aug-07 | 32   |                | 13,600,000       |                          | 12,595,187         | 95,780         | 156,356      | 32,413       | 221,183             |
| Sep-07 | 33   |                | 13,600,000       |                          | 12,562,773         | 95,780         | 156,356      | 32,413       | 221,183             |
| Oct-07 | 34   |                | 13,600,000       |                          | 12,530,360         | 95,780         | 156,356      | 32,413       | 221,183             |
| Nov-07 | 35   |                | 13,600,000       |                          | 12,497,947         | 95,780         | 156,356      | 32,413       | 221,183             |
| Dec-07 | 36   |                | 13,600,000       |                          | 12,465,533         | 95,780         | 156,356      | 32,413       | 221,183             |
| Jan-08 | 37   |                | 13,600,000       |                          | 12,433,120         | 95,780         | 156,356      | 32,413       | 221,183             |
| Feb-08 | 38   |                | 13,600,000       |                          | 12,400,707         | 95,780         | 156,356      | 32,413       | 221,183             |
| Mar-08 | 39   |                | 13,600,000       |                          | 12,368,293         | 95,780         | 156,356      | 32,413       | 221,183             |
| Apr-08 | 40   |                | 13,600,000       |                          | 12,335,880         | 95,780         | 156,356      | 32,413       | 221,183             |
| May-08 | 41   |                | 13,600,000       |                          | 12,303,467         | 95,780         | 156,356      | 32,413       | 221,183             |
| Jun-08 | 42   |                | 13,600,000       |                          | 12,271,053         | 95,780         | 156,356      | 32,413       | 221,183             |
| Jul-08 | 43   |                | 13,600,000       |                          | 12,238,640         | 95,780         | 156,356      | 32,413       | 221,183             |
| Aug-08 | 44   |                | 13,600,000       |                          | 12,206,227         | 95,780         | 156,356      | 32,413       | 221,183             |
| Sep-08 | 45   |                | 13,600,000       |                          | 12,173,813         | 95,780         | 156,356      | 32,413       | 221,183             |
| Oct-08 | 46   |                | 13,600,000       |                          | 12,141,400         | 95,780         | 156,356      | 32,413       | 221,183             |
| Nov-08 | 47   |                | 13,600,000       |                          | 12,108,987         | 95,780         | 156,356      | 32,413       | 221,183             |
| Dec-08 | 48   |                | 13,600,000       |                          | 12,076,573         | 95,780         | 156,356      | 32,413       | 221,183             |
| Jan-09 | 49   |                | 13,600,000       |                          | 12,044,160         | 95,780         | 156,356      | 32,413       | 221,183             |
| Feb-09 | 50   |                | 13,600,000       |                          | 12,011,747         | 95,780         | 156,356      | 32,413       | 221,183             |
| Mar-09 | 51   |                | 13,600,000       |                          | 11,979,333         | 95,780         | 156,356      | 32,413       | 221,183             |
| Apr-09 | 52   |                | 13,600,000       |                          | 11,946,920         | 95,780         | 156,356      | 32,413       | 221,183             |
| May-09 | 53   |                | 13,600,000       |                          | 11,914,507         | 95,780         | 156,356      | 32,413       | 221,183             |
| Jun-09 | 54   |                | 13,600,000       |                          | 11,882,093         | 95,780         | 156,356      | 32,413       | 221,183             |
| Jul-09 | 55   |                | 13,600,000       |                          | 11,849,680         | 95,780         | 156,356      | 32,413       | 221,183             |
| Aug-09 | 56   |                | 13,600,000       |                          | 11,817,267         | 95,780         | 156,356      | 32,413       | 221,183             |
| Sep-09 | 57   |                | 13,600,000       |                          | 11,784,853         | 95,780         | 156,356      | 32,413       | 221,183             |
| Oct-09 | 58   |                | 13,600,000       |                          | 11,752,440         | 95,780         | 156,356      | 32,413       | 221,183             |
| Nov-09 | 59   |                | 13,600,000       |                          | 11,720,027         | 95,780         | 156,356      | 32,413       | 221,183             |
| Dec-09 | 60   |                | 13,600,000       |                          | 11,687,613         | 95,780         | 156,356      | 32,413       | 221,183             |
| Total  |      |                |                  |                          |                    |                |              |              | 9,399,256           |

Total Staff - AWC

(220,985)

Higher Revenue Requirement And Lower Return

167,995

## Staff - AWC

|             |           |
|-------------|-----------|
| \$8,373,500 | \$180,592 |
| \$8,066,785 | \$184,051 |
| \$7,775,916 | \$187,180 |